Russia introduces changes in the taxation of income on securities and interest expense deduction

On 2 November 2013, Russia’s President Vladimir Putin signed the Law “On changes to first and second part of the Tax Code and other legislative acts of Russian Federation” (the Law), which introduces significant amendments to the Tax Code concerning the taxation of income on securities paid to foreign entities acting in favor of third parties. In addition, significant changes are to be introduced to a number of articles of the Tax Code, including the interest expense deduction.

New rules for determining the tax agent

The Law introduces rules for determining the persons/entities to be recognized as withholding tax agents, for instance, depending on the types of entities that hold securities and the types of accounts for securities. Under the Law, a depositary is to be regarded as a tax agent in relation to profits tax and personal income tax when paying income to foreign and Russian individuals and legal entities which are not recognized as participants in the professional securities market. The issuer of securities retains the tax-agent obligations in a fairly limited number of cases (i.e., when securities are kept in the register of shareholders on the owners’ accounts).

Withholding tax on payments to foreign legal entities acting in favor of third parties

The Law introduces changes to the procedure of tax calculation, withholding and reporting with respect to the income paid to foreign entities acting in favor of third parties.
Under the new rules, the depositary is responsible for calculating and withholding the tax due on the income paid on the following securities:

- State securities of the Russian Federation with mandatory centralized safekeeping;
- State securities of the constituent territories of the Russian Federation with mandatory centralized safekeeping;
- Municipal securities with mandatory centralized safekeeping;
- Issuance securities with mandatory centralized safekeeping issued by Russian organizations which underwent state registration or were assigned with ISIN after 1 January 2012;
- Other issuance securities issued by Russian companies, excluding the securities with mandatory centralized safekeeping which underwent state registration or were assigned with ISIN before 1 January 2012; if those securities are recorded in the following depositary accounts:
  - Depositary account of a foreign nominee holder;
  - Depositary account of a foreign authorized holder;
  - Depositary account of a depositary program.

**Application of the double tax treaty reliefs**

According to the Law, the provisions of the relevant double tax treaties should be applied in relation to dividend income as follows:

- The depositary acting as a tax agent should withhold tax at a reduced rate under the provisions of a relevant double tax treaty on the basis of “aggregate” reporting (as described further in this Tax Alert) if the application of the reduced rate is not subject to any special requirements envisaged by the respective treaty (such as the value of investment and/or ownership percentage in share capital);
- If the application of the reduced rate is subject to special requirements envisaged by the relevant double tax treaty (i.e. the value of investment and/or ownership percentage in share capital), the depositary acting as a tax agent should nevertheless withhold tax at a maximum rate, which is not subject to special requirements, established by the respective treaty. The refund of the excessively withheld tax should be claimed by a foreign taxpayer from the tax authorities.

For example, when paying income in the form of dividends to Cypriot investors, the depositary should withhold tax at a rate of 10%. Dividend recipients - tax residents in Cyprus, who invested more than €100,000 in the underlying Russian shares and are therefore entitled to a 5% withholding tax rate, should claim the refund of the excessively withheld tax from the Russian tax authorities.

According to the Law, an income recipient retains in full the right for tax benefits under the tax treaty, and only the mechanism of applying a tax relief is being changed. It should be specifically noted that the new rule of applying the double tax treaty reliefs should relate exclusively to the payment of dividends on the shares held by foreign entities acting in favor of third parties, as specified above.

It should also be noted that the tax refund procedure envisages the provision of information and documents confirming the right to a reduced tax rate. Individuals may also be requested to confirm payment of tax in a foreign jurisdiction.

The changes may have a positive impact on a number of market participants that hold Russian securities via foreign nominee/authorized holders. First of all, the holders of bonds, shares and depositary receipts should benefit from the new changes, since access to the treaty benefits is simplified for them. As far as the holders of
shares entitled to reduced tax rates are subject to special requirements (usually holders of a large stake in a company), the impact may be negative: a reduced tax rate may be applied via a refund only. So such investors may stand to gain if their rights concerning securities were recorded directly in the register. Accordingly, investors should analyze their current investment structures in order to identify the potential tax leakage and develop tax efficient alternatives for investing in Russian securities.

**“Aggregate” reporting**
According to the Law, the depositary, acting as a tax agent, should be provided with aggregate information on persons exercising their rights concerning securities, including the data on the amount of securities in question, and the jurisdictions of tax residence of the persons having the actual right to income and applicable tax rates.

However, the Law does not provide a definition of the “person exercising the rights concerning securities”. The “person having the actual right to income” is not defined either. That gives grounds for a wide interpretation concerning the persons to be reported to the tax agent.

Under the Law, it is not necessary to report the income recipients’ names or submit documents confirming their tax residency upon payment of income. These documents may be requested by the tax authorities during a desk or in-house audit of the tax agent.

**Reporting and payment deadlines**
Aggregate reporting should be provided by foreign entities acting in favor of third parties within the following deadlines:

- Securities with mandatory centralized safekeeping (i.e. bonds), within five days following the date when the depositary that performs mandatory centralized safekeeping of the securities discloses the information on income payment to the account holders;
- Equities issued by Russian organizations, within seven days following the date when the list of shareholders entitled to dividends is closed.

**Sanctions for non-disclosure**
In case the information envisaged by tax legislation was not duly provided to the tax agent, the income on the securities in question should be subject to tax at source at the “punitive” rate of 30% irrespective of the category of the person receiving the securities. The “punitive” rate does not apply to income which is tax exempt under the Russian Tax Code or a double tax treaty, as well as in cases when income is taxed at a 0% tax rate or the tax agent is relieved of the tax withholding obligations.

Under the Law, tax should be remitted to the state revenue on the 30th day following its calculation and withholding. If adjusted information is received, the tax agent should recalculate the amount of tax before the date the tax is due. Nevertheless, the tax agent may decline making tax recalculations if the adjusted information is provided in less than five days before the payment deadline.

**Tax audit**
The Law provides that the tax authorities may request a wide range of documents justifying the application of the reduced tax rate. The list of documents which may be requested under the desk and in-house tax audits is open. In turn, upon receipt of such request from the tax authorities, the tax agent is obliged to re-address the request to the foreign entities acting in favor of the third parties to provide the required documents.

**Who bears responsibility?**
The Law explicitly states that the tax agent is not liable for the tax unduly withheld due to the misstatements in the aggregate reporting received. It remains unclear who is liable for tax which was not withheld. It is also unclear whether the tax agent bears responsibility for not providing documents requested during a tax audit.

Although the depositories are exempt from tax liabilities for unduly withholding of tax, there is a lot of work to be done by them in implementing new procedures of interaction with their clients in relation to withholding tax. Russian depositories as well as foreign nominee holders/ asset managers should inform their clients of the forthcoming changes and the potential impact.
Taxation of income on state and municipal securities

The provisions of the Tax Code relating to the taxation of income on state and municipal securities have not been modified. When drafting the Law, it was proposed to tax such income at the rate of 0%, including the income paid to Russian residents. The website of the Russian Ministry of Finance informs that the potential leakage from state revenue is 26 billion roubles. According to the final version of the Law, the applicable tax rate remains unchanged. Likewise, Article 310.2.7 of the Tax Code, which exempts tax agents from the tax withholding obligation, remains in effect.

Other important changes

**Deduction of interest expenses**

The existing rules on the deduction of interest expenses have been prolonged to 31 December 2014. Although the Central Bank is planning to abandon the refinancing rate, the interest expense for 2014 will be calculated based on the refinancing rate and the multipliers 1.8 and 0.8 applied to rouble and foreign currency liabilities, respectively. In the meantime, the Task Force for Creation of the International Financial Center in Russia prepared alternative amendments to Article 269 of the Russian Tax Code, which may come into effect in 2015 at the earliest. According to these amendments, interest expenses should be calculated by applying the actual interest rate for interest deduction purposes. The taxpayer is to be obliged to justify the interest rate only on borrowings that are qualified as “controlled transactions” for transfer pricing purposes. Furthermore, there was a suggestion to implement safe harbor rules whereby if the interest rate is within certain interval it would be automatically accepted as being at market level.

**Payments on Eurobonds**

The Law clarifies that in the event of payment of interest income relating to Eurobonds, apart from a Eurobond issuer, foreign legal entities authorized to receive interest (i.e., trustees) and organizations to which the rights concerning Eurobonds have been reassigned may benefit from the withholding tax exemption as well.

**Taxation of income of the Closed Unit Investment Fund (CUIF)**

Income from the sale (including redemption) of units in real estate CUIF should be recognized as Russian source income.

**Date of entry into force**

On 3 November 2013, the Law “On changes to first and second part of the Tax Code and other legislative acts of Russian Federation” (the Law) was officially published. In part covered by this Tax Alert, the Law comes into effect starting from 1 January 2014.

There is a view that several provisions of the Law should be improved. Therefore, the Law may be amended during the next year. Future Alerts will cover legislative developments.

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